Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Alquist	Analyst:	Gail Hall	Bill Number:	SB 1750
Related Bills:	See Legislative History	Telephone:	845-6111	Amended Date:	April 23, 2008
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SUBJECT: Change Method Used To Assign Royalty Income To The Sales Factor

SUMMARY

This bill would provide a new rule for assigning certain receipts for inclusion in the formula that is used by a corporation doing business within and without California to calculate its franchise or income tax.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to provide 1) taxpayers and the Franchise Tax Board certainty and administrative simplicity, 2) a rule to encourage economic development in California in a manner consistent with the economic policy supporting adoption of the single sales factor, 3) consistency with several other California sales factor sourcing rules, and 4) a rule that closes a significant loophole and ensures fairness among taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately, and apply to taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS

FEDERAL LAW

The federal method of taxing corporations doing business within and without a state is different from the California method; therefore, federal law is inapplicable.

Board Position:			Department Director	Date
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STATE LAW

Apportionment

California has adopted the Uniform Division of Income for Tax Purposes Act, (UDITPA), with certain modifications, to determine how much of a corporation's business income is attributed to California and subject to California franchise or income tax. UDITPA uses an apportionment formula to determine the amount of "business" income attributable to California.[1]

The apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction the numerator of which is the value of the item in California and the denominator of which is the value of the item everywhere. The property factor includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor generally includes all gross receipts from the sale of tangible and intangible property and is double-weighted.

The calculation of the apportionment formula and California business income is illustrated below.

$$\frac{\boxed{\frac{\text{Average CA Property}}{\text{Average Total Property Everywhere}}} + \boxed{\frac{\text{CA Payroll}}{\text{Total Payroll Everywhere}}} + \left(2 \times \boxed{\frac{\text{CA Sales}}{\text{Total Sales Everywhere}}}\right)}{4} = \text{California Apportionment Percentage}$$

X Total Business Income
= California Business Income

The numerator of the sales factor is total sales in California during the taxable year and the denominator is the total sales everywhere during the taxable year.[2] The definition of "sales" is all gross receipts that are from business activities.[3] State law provides numerous rules for assigning sales to California. These rules categorize sales as either sales of tangible personal property[4] or sales other than sales of tangible personal property.[5] This bill deals with sales other than sales of tangible personal property.

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[1] Revenue and Taxation Code (R&TC) section 25120(a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."
[2] R&TC section 25134.
[3] R&TC section 25120(e).
[4] R&TC section 25135.
[5] R&TC section 25136.

Determination of California Sales Other Than Sales Of Tangible Personal Property for Sales Factor Purposes

In general, sales from intangibles (i.e. patents, licensing agreements, copyrights, and trademarks) are assigned to California if 1) the income-producing activity is performed in this state, or 2) if the income-producing activity is performed within and outside the state and a greater proportion of the income-producing activity is performed in the state, based on costs of performance. “Income-producing activity” applies to each separate item of income and is defined as the transactions and activities directly engaged in by the taxpayer in the regular course of business (items like research, design, engineering, product design, and customer support services). “Costs of performance” means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business (costs for such things as salaries, supplies, equipment, and office expenses).[6]

The following are special rules that deviate from the general rule for assigning sales to the state where the greater costs of performance were incurred.

1. Receipts from the sale, lease, rental, or licensing of real property are assigned to the state where the real property is located.
2. Receipts from the lease, rental, or licensing of tangible personal property are assigned to the state where the tangible personal property is located. If the property is used in more than one state, the receipt is assigned based on the ratio of the time the property is used in the state to the total time it was used everywhere. Each time use is considered a separate item of income.
3. Receipts from “personal services” performed within and without the state are “usually” separate income producing activities and are assigned based on the ratio of time spent in performing the service in the state to total time performing the service everywhere.

If there is no identifiable income-producing activity, the receipts from the sale other than sales of tangible property are excluded from the sales factor.

Worldwide Versus Water’s-Edge Filers

If a taxpayer uses the worldwide unitary method to file its state taxes, its unitary business income and apportionment factors from both domestic and foreign operations are considered in the calculation of state tax. As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their business income on a "water's-edge" basis. In general, the water’s-edge method excludes foreign corporations from the water’s-edge combined report (water's-edge combined reporting group). There are exceptions to this general rule as some affiliated foreign corporations, if unitary with an entity that is a water’s-edge taxpayer, are includable in the water’s-edge combined reporting group if certain requirements are met.[7]

[6] California Code of Regulations (CCR), title 18, Section 25136.
[7] R&TC section 25110(a)(1) and (2).

Intercompany Transactions

The definition of an intercompany transaction is a transaction between corporations that are members of the same combined reporting group immediately after such transaction.[8] When transactions occur between members of a group, the individual members may realize a gain, loss, deduction, or income, but there will be no economic effect to the group as a whole. For example, if Corp A and Corp B are members of a water's-edge combined reporting group, and Corp A pays a royalty to Corp B, Corp A will report royalty expense and Corp B will report royalty income in the same amount, therefore the intercompany transactions zero each other out.

THIS BILL

This bill would do the following:

- Create a new rule for an apportioning taxpayer that receives a royalty payment for a patent or other technology know-how, trade names, or trademarks from a unitary corporation whose income and apportionment factors are not included in the taxpayer's combined reporting group.[9] Under existing law, this would only occur when an apportioning taxpayer that is a member of a combined reporting group receives such a payment from a unitary corporation that is not included within the taxpayer's water's edge combined reporting group.

- Assign receipts from royalty payments and other technology know-how, trade names, or trademarks to California if the sale of tangible personal property or services giving rise to the royalty or other payments are in California.

- Provide that a taxpayer is presumed to have properly reported the amount of royalty income or other receipts for patents and other technology, know-how, trade names, or trademarks, if the taxpayer assigns the amount of royalty or other receipts to California based on a percentage, the numerator of which is the total unitary group's (all corporations in the water's-edge combined reporting group plus excluded unitary foreign corporations) product and service receipts in California related to the total intercompany royalty or other such payments not eliminated from the sales factor, and the denominator of which is the entire unitary group's product and service receipts related to royalties or other such payments not eliminated from the sales factor. This presumption may be rebutted upon showing that the use of the formula would result in an amount of income apportioned to California that is incongruous with the intent of this paragraph.

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[8] CCR, title 18, Section 25106.5-1(b)(1).
[9] R&TC section 25110(a)(1).

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. On page 2, line 21, it is unclear what "presumed to have properly reported" means. In addition, it is unclear what the author means by the "presumption may be rebutted upon showing that the use of this formula would result in an amount of income apportioned to this state that is incongruous with the intent of this paragraph." One could interpret this to mean that the receipts assigned to California would be presumed correct by the department and not subject to audit if it was the intent of the taxpayer to use some type of "market" approach for assigning sales to California. Perhaps this is meant to shift the burden of proof to the Franchise Tax Board if the presumption is met. If so, it is unclear how the Franchise Tax Board could overcome this presumption.
2. Because this bill only applies the alternative method in cases where the royalties are received from unitary affiliates outside the water's edge, the proposal would force the Franchise Tax Board to look at the unitary relationships of all of the royalty paying entities to determine which entities are members of the unitary group such that its royalty payments would fall under the new scheme. This runs contrary to the policy of the water's edge election, which eliminates most foreign entity inquiries in an effort to simplify the reporting method for taxpayers.
3. The new methodology appears to require that the sales of all members of the unitary group (including the foreign entities not included in the water's-edge combined reporting group) that give rise to the royalty must be examined in order to assign the royalty. This would require inquiry by the Franchise Tax Board into the operations of entities excluded from the combined reporting group by virtue of the water's edge election. Under current law, there is no need to perform such inquiries as the specific purpose of the water's edge election is to limit the scope of the combined reporting group to only entities within the water's edge, as defined by current law.

TECHNICAL CONSIDERATIONS

The department has identified the following implementation considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. On page 2, the use of the word "intercompany" is inconsistent with current law's definition of intercompany transactions because it appears the author is referring to payments made by unitary foreign entities that are not members of the water's-edge combined reporting group (see intercompany transaction definition under the State Law section). The author should consider removing references to intercompany transactions.

2. On page 2, line 14, the author should consider revising "receipts of unitary intercompany royalty or other payments for patents and other technology, know-how, trade names, or trademarks" to ensure this language is complete and that each term (i.e. know-how) is defined.

3. The bill refers to intercompany receipts to the extent not "eliminated." The author should consider replacing "eliminated" with "taken into account" because current law does not refer to "intercompany transactions" as eliminations.

4. This bill applies to receipts of unitary intercompany royalty or other payments to the extent not eliminated from the sales factor pursuant to California Code Of Regulations, title 18, Section 25106.5-1. The department has assumed this reference means receipts from a unitary foreign corporation that is not included within the taxpayer's water's edge combined reporting group. One may interpret this reference to include domestic and foreign insurance companies, S corporations, and partnerships. The author should consider revising the language to clarify this reference and to prevent possible disputes between taxpayers and the department.

OTHER STATES' INFORMATION

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Research was performed to determine how these states assign receipts similar to royalties to their respective sales factor. Research found that these states applied their rules for assigning royalties and similar type receipts utilizing the same rule for all of these receipts. The approach used by these states differs from this bill. This bill would create a rule only for assigning royalties and similar types of receipts that are received by a water's-edge taxpayer from a unitary foreign entity excluded from the water's-edge combined reporting group.

Florida assigns gross receipts from the sale or licensing of the use of a trade name, trademark, or patent to the state in which the trade name, trademark, or patent is used.

Illinois assigns gross receipts from the licensing, sale, or other disposition of a patent, copyright, trademark, or similar item of intangible personal property to *Illinois* to the extent that item is used in the state during the year and the gross receipts are included in gross income. A patent is used in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If a patent is used in more that one state, the patent gross receipts would be assigned to *Illinois* based on a ratio. A copyright is used in a state to the extent that printing or other publication originates in the state. If the copyright is used in more that one state, the receipts are assigned to *Illinois* based on a ratio. Trademarks and other items of intangible personal property are used in the state in which the commercial domicile of the licensee of purchaser is located.

Illinois law provides that gross receipts from the license, sale, or other disposition of patents, copyrights, trademarks, and similar items of intangible personal property may be included in the numerator or denominator of the sales factor only if gross receipts from licenses, sales, or other disposition of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the two immediately preceding tax years; provided that, when a taxpayer is a member of a unitary business group, such determination shall be made on the basis of the gross receipts of the entire unitary business group.

Massachusetts generally assigns receipts from copyrights, patents, trademarks, trade names, trade secrets, contract rights, and similar intangibles to *Massachusetts* to the extent that the intangible property is used by the licensee in *Massachusetts*. A sale of intangible property that resembles a license, such as a contingent payment sale, is treated as a license. Each use of intangible property by a licensee that results in a separately identifiable item of income for the taxpayer is considered a separate use of the intangible property.

Michigan assigns royalties and other income received for the use of or for the privilege of using intangible property, including patents, know-how, formulas, designs, processes, patterns, copyrights, trade names, service names, franchises, licenses, contracts, customer lists, computer software, or similar items, to the state in which the property is used by the purchaser. If the property is used in more than one state, the royalties or other income are apportioned to *Michigan* on a pro rata basis according to the portion of use in *Michigan*. If the portion of use in *Michigan* cannot be determined, the royalties or other income are excluded from both the numerator and the denominator of the sales factor. Intangible property is used in *Michigan* if the purchaser uses the intangible property or the rights to the intangible property in the regular course of its business operations in *Michigan*, regardless of the location of the purchaser's customers.

Minnesota assigns royalties and other types of income including patents, know-how, formulas, designs, processes, patterns, copyrights, trade names, service names, franchises, licenses, contracts, customer lists, or similar items, to the state in which the property is used by the purchaser. If the property is used in more than one state, the royalties or other income must be apportioned to this state on a pro rata basis according to the portion of use in this state. If the portion of use in this state cannot be determined, the royalties or other income must be excluded from both the numerator and the denominator of the sales factor. Intangible property is used in this state if the purchaser uses the intangible property or the rights therein in the regular course of its business operations in the state, regardless of the location of the purchaser's customers.

New York assigns receipts of royalties from the use in *New York* State of patents and copyrights to *New York*. Royalties include all amounts received by the taxpayer for the use of patents or copyrights, whether or not such patents or copyrights were issued to or are owned by the taxpayer. A patent or copyright is used in *New York* State to the extent that the activities are carried on in the state.

FISCAL IMPACT

The department's costs to administer the amendments cannot be determined until the department's implementation concerns have been resolved.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Table 1: Estimated Revenue Impact of SB 1750 Effective for tax years BOA 1/1/2008 Enacted after 6/30/2008 ($ in Millions)				
	2008-09	2009-10	2010-11	2011-12
Impact from taxpayers paying higher taxes	$3	$4	$4	$4
Impact from taxpayers paying lower taxes	-$9	-$11	-$12	-$12
Net revenue impact	-$6	-$7	-$8	-$8

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of this bill was estimated as the difference in the tax revenues collected under current law and the provisions proposed under SB 1750. Simulations based on the FTB 2005 corporation sample data indicate that this bill would result in higher taxes for some water's-edge corporations, and lower taxes for others.

Water's-edge corporations that have research and development facilities (income producing activities) in the state would pay lower taxes under this bill because royalty receipts that were assigned 100% to California would now be assigned to the state based on where the product or service was used. A portion of these royalty receipts would be excluded from the numerator of the sales factor, resulting in a lower California apportionment percentage. For the 2005 tax year, it was estimated that this bill would lower the tax liabilities of these corporations by approximately $6 million.

Water's-edge corporations that have research and development facilities outside of the state would pay higher taxes under this bill because royalty receipts that were assigned 100% outside of the state would now be assigned to the California if the product or service was used in the state. Under this bill a portion of these payments would now be included in the numerator of the sales factor, resulting in a higher California apportionment percentage. For the 2005 tax year, it was estimated the bill would raise the tax liabilities of these corporations by about $1 million.

The above estimates for the 2005 taxable year were extrapolated into the future using the Department of Finance projected corporate profit. These amounts were converted to cash flow fiscal year estimates as shown in the above table. For example, the 2008-09 revenue loss of -$6 million includes a loss of -$3 million from the 2008 taxable year, plus a loss of -$3 million from the 2009 taxable year due to reduced estimated and final tax payments.

ARGUMENTS/POLICY CONCERNS

1. This bill would create a second rule for assigning receipts from royalties and similar types of income to the sales factor that is based solely on the relationship of the entity making the payment has to the water's-edge taxpayer receiving the payment. This is different from the treatment of these same types of receipts in other states and would add complexity to current law because there would be two rules to follow for the assignment of receipts from royalties and similar types of income to the sales factor.

2. The percentage used by this bill to assign receipts to the sales factor would be based on an aggregate of total product sales and services of all royalties and similar type receipts in California over the aggregate of total product sales and services of all royalties and similar type receipts in the unitary group. Aggregating instead of calculating the percentage for each item of royalty income could result in the assignment of receipts that lack a relationship to the market. For example, a taxpayer may receive a small royalty that relates to a large amount of product sales made to foreign countries. In addition, that same taxpayer may receive a large royalty receipt that relates to a medium amount of product sales in California. By using a percentage that aggregates the product sales relating to the two royalties, the overseas product sales could dilute the amount of receipts that would be assigned to California. The author should consider requiring the percentage to be calculated based on each separate item of income.

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